RESULTS PACKAGE

Microfinance Industry Strengthened for Access
of the Poor to Financial Services

Latin America and the Caribbean (LAC/RSD)

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TABLE OF CONTENTS

RESULTS PACKAGE

Microfinance Industry Strengthened for Access of the Poor to Financial Services Latin America and the Caribbean (LAC/RSD)

I. INTRODUCTION

Several dozen of the region's microfinance service providers have achieved a level of full financial sustainability. Once highly dependent on donor funds, these institutions no longer require subsidies to survive. The implication of this fact is that the development goal of widespread financial services for the poor potentially can be financed and implemented in the open market. Now that sustainability has been demonstrated, should international donors claim success and, as some have already done, begin to shift microfinance assistance funding from LAC to other regions?

A deeper analysis of the current state of LAC microfinance reveals a still fragile and underdeveloped sector. Consider the following:

(1) Rough estimates show that well under five percent of the potential microfinance market is currently being served,
(2) Most MFIs do not offer important non-credit financial services, such as savings and insurance,
(3) The level of penetration of microfinance into rural areas in LAC is very low,
(4) Laws, regulations and other industry level initiatives have not been adequately addressed. This continues to retard the healthy commercialization of the sector.

Whereas initial microfinance programs emphasized a relatively simple formula of loan recovery and portfolio expansion, these second generation challenges are more difficult and complex. Less funding may be needed, but the quality of assistance must be especially high.

Despite a shift in some donors' focus from Latin America to Africa, there are still numerous donors providing major microfinance funding to the LAC region. Some initiatives, such as institution building, are receiving adequate attention. But there are other areas that require more assistance. LAC/RSD will limit its support to these areas.

In further narrowing the strategy, LAC/RSD has considered a few important comparative advantages. These are its (1) regional focus, (2) relationship with as many as 15 USAID field Missions, and (3) its close proximity to other major donors and international NGOs.

These considerations, as well as its limited technical and financial resources, led LAC/RSD to its *technical* and *methodological* approaches to the strategy. Technically, the program will emphasize second generation challenges that are common across the region and that are sectoral in nature. Although at least four potential sectoral issues are identified and developed within the Results Framework, the Bureau may consider choosing as few as one or two of these.

Methodologically, the program will provide host country counterparts with the tools they need to develop and implement sector level initiatives. This will begin with the effective dissemination of current knowledge and experience, followed by specialized technical assistance. These efforts must be accompanied by active host country leadership and participation, which is requisite for success.

The benefits of some of these sector level solutions will be much greater than they would be by supporting individual institutions. A new licensing and regulatory structure or a new credit bureau, for instance, could result in a major expansion in financial service access at the frontier. If successful, it also could have a positive demonstration effect for other countries to follow.

II. PROBLEM ANALYSIS AND RATIONALE FOR LAC/RSD PROGRAM

A. Problem Analysis

The high incidence of poverty and the skewed distribution of income in most Latin American countries are indicative of the pervasive lack of economic opportunities that continue to afflict the poor in those countries. Microfinance institutions already have made a significant difference in the lives of over a million of the hemisphere's poor. Many MFIs are expanding their outreach to the poor by an annual rate of over 15 percent. Thus, the results and growth trends of MFIs are generally positive. However, the magnitude of the poverty problem, estimated at two hundred million people, emphasizes the need for the continued expansion of MFIs.

Microfinance in the LAC region has grown at a rapid pace during the 1990s. The industry has become large and complex. Different countries are varied stages of development, but there are distinct trends and challenges with respect to (A) the continued development of MFIs and (B) the sector-level environments in which MFIs operate. These are described in the sections to follow.

1. <u>The Maturing Process of MFIs</u>

As a region, Latin American microfinance has developed more quickly and successfully than any other region. A greater percentage of poor Latin Americans have access to microfinance services than the poor from any other region in the world. One of the best indicators to measure and predict the health of a microfinance sector is the level of financial sustainability of MFIs that deliver the services. The following table, which includes data from USAID-assisted institutions only, illustrates Latin America's progress in these terms:

	Not Yet Sustainable (%)	Operationally Sustainable (%)	Financially Sustainable (%)
Africa	83	11	6
Asia/Near East	89	1	10
Europe/Eurasia	82	7	11
Latin America/Caribbean	39	30	31

While only less than 15 percent of the MFIs outisde of the region have reached operational sustainability, over 60 percent of MFIs in LAC achieved this threshold. This fact has important implications for microfinance sector planning and assistance in the different regions.

MFIs in the LAC region have demonstrated they can deliver loans to low income clients on a sustainable basis. For reference purposes, this can be called Phase I of the region's microfinance development. This phase is analogous to a young company experiencing explosive growth thanks to unmet demand for its innovative new product. This is when the entrepreneur thrives.

In the case of microfinance, it was the methodological approaches developed by Accion and other institutions that brought initial success and spurred growth. Developed with the backdrop of large informal urban economies and increasingly liberal financial systems, these programs proved that poor microenterprise clients are a good risk. The methodologies consisted of the following critical elements:

- Uncollaterized loans, based on the client's character and/or group guarantees, and an evaluation of repayment capacity of the business,
- Very small initial loans which increase as lender/client confidence builds,
- Short loan periods (six months or less) with frequent payments (usually weekly),
- Immediate follow-up on delinquent loans.

Institutions that combined this methodology with sound financial policies and competent management grew as much as 100 percent annually during their first few years of operation. During these first years, most institutions were concerned with accessing capital to finance their growth and with finding technical and administrative expertise to strengthen their institutions. As a result, by 1999 dozens of institutions have:

- reached economies of scale with tens of thousands of clients,
- developed adequate information systems, and,
- developed strong financial management capacity.

Many of the larger, more established MFIs have experienced a slowdown in growth and an increase in competition. They are now faced with a new set of challenges. The situation is analogous to the company whose growth begins to slow, competition sets in and external factors such as regulation become increasingly important. This is when the company needs to improve efficiencies, diversify its products and find new markets.

Many institutions have not fully completed Phase I of their development, and will requrie continued support in the areas of institutional strengthening and loan portfolio financing. But there is a growing mass of institutions that have entered Phase II and are beginning to address the following two areas:

Operational Efficiency

- Utilization of new technologies such as hand-held computers,
- Credit scoring as a supplementary means of evaluating clients,
- Segmentation of clients,
- Recruitment and training of better qualified personnel.

Diversification of Products and Markets

- New loan products based on market segmentation,
- Other financial products including client savings, insurance, and leasing,
- New geographical markets, including rural areas.

Phase II of the region's microfinance development may not have the profound development significance as Phase I, but the technical challenges will be more difficult. They will require inside managers and outside consultants with excellent information, as well as the knowledge judgement to identify the precise areas that need to be addressed. Once identified, highly specialized technical expertise will be required.

The "commercialization" of microfinance in LAC has also progressed more rapidly than in other regions. Microfinance services, particularly in South America, are in large part provided by regulated institutions. What varies are the types of institutions and the manner in which they evolved. In Bolivia, the great majority of services are provided by BancoSol and other entities with NGO origins. Chile is at the other extreme, where the major microfinance service providers are commercial banks. Their micro credit programs are just one facet of their highly diversified portfolios. Paraguay's microfinance sector has evolved with both types of institutions, including NGOs that have up-scaled as well as banks that have downscaled. And then there are credit unions, which exist in all these countries and are becoming increasingly involved in the microfinance sector. Their target market of the lower-middle income class and their socially oriented philosophies make the expansion into microfinance a relatively natural progression. The extent of commercialization of microfinance in different LAC countries differs greatly. While commercialization has progressed dramatically in most of South America, the great majority clients in Central America and the Caribbean are serviced by unregulated not-for-profit institutions.

The proliferation of microfinance institutions throughout the region also presents some unique problems. First, due to the competition that has been created, some institutions will have difficulty reaching the scale of operations necessary to become sustainable. Second, although a few traditional financial institutions have begun to offer microfinance services, others have resisted entering the market because of what they perceive as a market over-saturated with institutions, especially with unregulated NGOs. In order for these institutions to "downscale" their operations into microfinance, a readjustment of existing markets will likely be necessary through mergers and other measures.

2. MFIs Can't Grow in a Vacuum

Until now, most MFIs have been treated as "development projects," receiving large donor subsidies and operating in relatively isolated environments free of competition and regulation. This approach has built some strong institutions that, by and large, operate in weak and poorly developed microfinance markets. There has been scant attention given to better understanding external factors and to begin addressing these factors. As mature

MFIs confront the new challenges of expanding and diversifying their operations, they have begun to confront these external issues that are more systemic in nature.
In almost all new, growing industries the development of policies, regulations, standards and industry-wide associations occurs as a response to the initial success of individual institutions. Microfinance is no exception to this. Until recently, the majority of MFIs enjoyed growth without transparency, i.e. they did not share information about their institution or about their clients with anyone else. Although this situation may have seemed preferable to them, the absence of industry-wide initiatives has and will continue to retard the maturing process of MFIs. What follows are brief descriptions of some of the more relevant sector level issues affecting microfinance in the region.

Lack of a Regulatory/Supervisory Framework:

MFIs that want to become full service financial intermediaries for the microenterprise sector cannot do so without a license from an independent supervisory body. Few if any governments will allow institutions to mobilize deposits from the public without prudential oversight. Moreover, continued MFI loan portfolio growth will be severely restricted without a license. Currently, most unlicensed MFIs have debt-equity ratios of between 1:1 and 2:1. Their portfolio growth is limited by their equity. A license from a regulatory authority would increase this ratio many fold, in some countries up to 12:1 (as defined by the widely adopted standards of the Basel Committee). It is this license which has allowed BancoSol in Bolivia to leverage its approximately $8 million in equity to about $75 million by the end of 1998.

While Bolivia and Peru have enacted legislation to regulate and supervise MFIs, most of the region's MFIs are unable to obtain a license in their respective countries. Regulatory authorities in some other countries are open to the possible development of new legislation because current financial legislation has proved too formidable an entry barrier for MFIs. In particular, the minimum capital requirements, which in most cases were set for commercial banks, are too high. As most MFIs are NGOs, legal status and ownership requirements also present insurmountable barriers.

Lack of Microfinance Credit Bureaus:

Over the past decade, nascent microfinance programs had neither the need nor the capacity to check the credit records of potential loan clients. Few microenterprises had ever received formal credit. The MFIs operated in wide open, virgin markets with little or no competition and the cream of the potential credit client crop was available to them. At that time, reasonably well managed institutions with sound methodologies were able to maintain high repayment rates while growing aggressively.

This has all changed. First, many markets, especially in urban areas, have become saturated or nearly saturated with micro credit services. It has become increasingly difficult for MFIs to attract high quality first-time clients. The risk profile of new clients in these environments is relatively high. Second, competition among MFIs in the same markets has led to the practice by clients of accessing multiple loans from multiple institutions at the same time. This has led to over indebtedness. Third, MFIs are servicing increasingly large loans, partly as a result of the growth in their clients microenterprises, and partly as a result of efforts to serve slightly larger enterprises that have larger credit needs. Finally, some countries have recently experienced rapid growth in their consumer credit markets, which in part overlap with the microenterprise credit markets. Consumer credit programs employ a less stringent methodology for evaluating and approving loans, and as a result they must tolerate generally higher client delinquency rates. In some countries there are consumer credit companies that will grant credit to clients to customers who can prove they are current clients of reputable MFIs. The comparatively reckless practices of the consumer credit sector has begun to “pollute” the portfolios of some MFIs.

The MFIs operating in maturing markets have recognized the strong need for well functioning credit bureau systems. Timely information about potential clients would be an effective tool in limiting delinquency problems caused by the phenomena described above. In those countries where MFIs are regulated, the entities responsible for supervising MFIs also have a strong interest in a credit bureau. The Superintendency of Banks and Financial Institutions in Bolivia has implemented an on-line credit checking system for all licensed financial intermediaries, including MFIs. In El Salvador, where most of MFIs are unregulated NGOs, these institutions have formed their own private credit bureau called INFORED. These two initiatives are positive steps, but more must be done in these countries and others to create truly sector-wide, all-inclusive credit bureau systems.

Inadequate Human Resource Capabilities:

Many MFIs in Peru, Bolivia, El Salvador, Nicaragua, Ecuador and other countries have cited the lack of adequate human resources as an obstacle to healthy growth. This has been a result of several factors. First, the sheer growth of the industry has largely tapped the limited pool of qualified personnel, especially at the middle management level. Second, increased competition and a maturing market (as described in Section A above) has resulted in a need for greater sophistication by MFIs in developing new products, increasing efficiencies and improving marketing. Third, the formalization of MFIs, especially with regard to regulation and supervision, will require more comprehensive and sophisticated reporting.

Since local labor markets in most countries cannot produce the level of personnel now required for the microfinance industry, the skills of MFI employees will have to be upgraded through quality training programs. Training courses for microfinance are becoming more prevalent throughout the region, but authorities complain that these courses do not respond to their institutions’ needs. There are still only a few institutions in the region that specialize in microfinance training, and very little has been accomplished in developing quality curricula and training materials for the sector. There are two new regional training programs, COLCAMI in Mexico and FUNDA-PRO in Bolivia, which have developed specialized microfinance training programs. It is still too early to access the effectiveness of these institutions.

Absence of Framework for Secured Transactions:

Great progress has been made in providing credit access to microenterprises. And the generally healthy, growing commercial banking systems throughout the region are providing access to medium and large enterprises. There still remains a largely unserved sector: the small enterprise sector. The expansion of lending to growing microenterprises and small enterprises is important to economic growth in the region and to the continued growth and diversification of MFIs. Unfortunately, the effectiveness of micro lending technology diminishes as loan amounts increase.

Many growing microenterprises and small enterprises have built up assets in movable property, such as equipment and inventories. And although some financial institutions may have the resources and inclination to lend to these enterprises, the legal and regulatory framework does not allow the use of movable property as collateral. Without a major fixed asset, usually building or land, these enterprises are shut out from the credit market. Most of the LAC countries need to develop coherent legislation and regulations governing secured transactions. Some initial work has been undertaken in Mexico, Bolivia and Trinidad and Tobago, but it has been sporadic. The process is complicated, and requires the participation of the numerous government authorities (legal and financial) as well as the private financial sector. But the potential benefits are significant, as banks could expand their lending bases, particularly to smaller enterprises and new debtors.

MFI Inability to Self-evaluate:

As explained earlier, many MFIs have continue to operate in isolation and without transparency. Furthermore, some institutions with million of dollars in loan portfolio are unable to produce useful financial statements. This prevents them from evaluating their strengths and weaknesses with respect to similar institutions, as well as from identifying areas for improvement. The absence of objective financial data and institutional information also prevents these institutions from accessing both donor assistance and commercial capital. Donors are developing more stringent requirements in evaluating potential beneficiaries. Commercial investors, on the other hand, simply will not consider a debt or equity investment in an MFI without the full disclosure of reliable financial statements.

Cold data on MFI productivity, efficiency, portfolio quality and profitability would lead to useful comparative analyses and would force institutions to become more competitive. While CGAP and the IDB have developed useful criteria to evaluate MFIs, only recently has the Private Sector Initiatives Corporation (PSIC) developed a comprehensive tool for rating microfinance service providers. PSIC has established a set of standardized indicators (which can be adjusted for inflation and other factors) for the industry in the LAC region, and has conducted systematic assessments of 17 leading MFIs. The work represents the most comprehensive and reliable data on MFIs to date. Still, the majority of MFIs have not been rated. And in order to be useful over time, evaluations must be conducted at least every three years.

The following chart reflects the new areas being addressed by MFIs as well as the corresponding sector-wide phenomenon that also needs to be addressed:

MFI Challenge		Sector-wide Solution
Develop Savings and Other New Services Access Commercial Capital	→	Be Licensed, Regulated and Supervised By an Independent Prudential Body
Maintain Low Delinquency and Prevent client over indebtedness	→	Create a well functioning Credit Bureau on Microfinance Clients
Have higher qualified personnel In a more Sophisticated and Competitive Environment	→	Create high quality national level and regional training capabilities
Extend credit services to Small Enterprises.	→	Pass national level legislation and Implement regulations to permit use Movable property as collateral for loans.
Improve efficiencies and Increase competitiveness	→	Access rating information on other MFIs (public information).

B. Other Donors, Key Partners

The challenge of Phase II, which is to solidify, diversify and formalize microfinance in LAC, will require continued support from donors and other key partners. Only a handful of MFIs in LAC (or in the world, for that matter) have attracted private commercial investment. Even with such investment, institutions have very limited funds budgeted for research and development activities.

There are a number of organizations providing support to the region’s institutions and microfinance sector initiatives. Most of the assistance consists of direct support to MFIs for loan portfolio growth and institutional strengthening. An increasing body of support is being directed at supporting sector-wide initiatives that are important to the development of strong, well functioning microfinance sectors. These include programs to develop regulatory and supervisory structures, credit bureaus, training programs for MFI employees and other relevant policy and regulatory efforts. Following is a synthesis of the activities being carried out by institutions working in the region:

Inter-American Development Bank (IDB):

The IDB is the region's largest microfinance donor, having approved over $107 million in million for the sector in 1998. Another $500 million in investments is planned for over the next five years. The IDB has a wide variety of instruments to support the sector, and a large staff of technical experts to implement its programs, which include:

- Small project soft loans and associated technical cooperation,
- Equity investments executed by the Multi-lateral Investment Fund (MIF),
- The Line of Activity Program consisting of small technical assistance projects to aimed at strengthening the capacity of MFIs, and
- Two national-level global micro and small enterprise development programs in Bolivia and Peru,
- The Latin American Challenge Investment Fund (LA-CIF) which provides intermediary guarantees of credit to MFIs.

The IDB also carries out programs to promote and disseminate microenterprise best practices, and to build consensus among government bodies and international institutions about microfinance.

The Consultative Group to Assist the Poorest (CGAP):

Although there is no official international coordinating body on microfinance, CGAP plays this role in many respects. CGAP is comprised of 26 organizations, mostly multi-lateral and bi-lateral development agencies. It was established in large part to improve the quality of donor assistance to the microfinance sector. In its first three years since being launched in 1995, CGAP:

- Established mechanisms for increased interaction and shared understanding among 26 donor agencies regarding microfinance,
- Disseminated best practice messages globally to practitioners, policymakers, and donors, and
- Developed a performance-based funding approach to MFIs.

With about $10 million in annual funds, CGAP will emphasize the following themes over the next four years:

1. Support institutional development in the microfinance sector.
2. Support changes in donor practices to further improve the quality of their microfinance programs.
3. Increase understanding on poverty outreach to MFIs.
4. Improve the legal and regulatory framework for MFIs.
5. Facilitate "commercialization" of the microfinance industry.

USAID's Microenterprise Unit:

The Global Bureau's Microfinance Unit developed the Microfinance Innovation Project to channel support to the sector. The program consists of five components, two of which provide grants to MFIs (PRIME) and international NGOs (IGP) to support institutional expansion and strengthening. A third component, MICROSERVE, provides technical assistance to strengthen MFIs. The Unit's two R&D tools include the Microenterprise Best Practices (MBP) and Assessing the Impact of Microenterprise Services (AIMS) projects. The MBP project has conducted research and comparative studies on topics such as the commercialization of microfinance, supervision and regulation, savings mobilization, rural financial services, as well as upcoming work on credit bureaus. This program, in its last year, was slow to begin and has not developed its dissemination of best practices activities as well as it had planned. AIMS conducts rigorous research on the impact of microfinancial services and assists in finding ways to develop more effective use of information systems. The Unit has averaged approximately $25 million in expenditures annually over the past three years.

USAID's Bureau for Humantiarian Response (BHR):

BHR implements an annual matching grant program for NGOs. The program, which supports U.S. NGOs such as Accion International and PLAN, finances a wide variety of activities to support sustainable delivery of microfinance services. The program has averaged above $8 million annually in expenditures over the past three years.

USAID Missions:

There are 12 USAID Missions in LAC that are currently implementing activities to support microfinance development in their countries. Most of the programs include a variety of components, of which institutional strengthening of MFIs is one of the most common. Some Missions are either utilizing or exploring the possibility of accessing commercial capital for MFIs, including the use of guarantee schemes. Several MFIs have accessed assistance under programs implemented by the Global Bureau's Credit and Investment Staff, including PRODEM and FIE in Bolivia, and Banco Solidario in Ecuador. A new program, the Development Credit Authority (DCA), will provide another guarantee option for Missions.

Several Missions are supporting the development of new services and markets, including the mobilization of savings and the development of rural financial services. At least five Missions are implementing or have expressed interest in supporting the implementation of effective regulatory and supervisory structures. Some Missions are exploring the development of credit bureaus for the systems in their countries, and the El Salvador Mission has completed the successful creation of a private credit bureau (INFORED) for microfinance NGOs in that country. Several Missions are supporting local institutions in improving the quality of MFI human resources through business institutes, universities and other institutions. Finally, a number of Missions are providing support to credit unions and credit union systems to allow these institutions to develop instruments in support of the microfinance sector. In some countries, including Ecuador and Bolivia, credit unions are becoming an important source of microfinance services.

Other Bi-lateral Donors:

Dozens of bi-lateral donors, international NGOs, church organizations and others are providing some kind of support to microfinance in the region. Of these, two of the most important are the German and Swiss bi lateral organizations. The Germans, in particular, have provided effective assistance to MFI institutional development mainly through the well regarded private firm IPC. The Germans have also provided support in the development of regulatory and supervisory structures, including in Bolivia. The Swiss provide a wide range of support, including institutional strengthening, the development of new services. They have also provided support in several countries on policy and regulatory issues. These and other bi lateral organizations are important potential partners for LAC/RSD.

NGOs and Universities:

U.S.-based NGOs and universities have conducted some of the best research and technical support to microfinance in the LAC. USAID and other donors have provided most of the financing used by these institutions. The following list is not meant to be exhaustive, but includes some of the principal institutions:

> **Accion International**: provides technical support to affiliate institutions throughout the region. Much of this assistance is for institutional strengthening, although an increasing amount is for research and development. Accion has participated in the development of debt and equity instruments to increase the capital of MFIs, including a guarantee scheme called the Gateway Fund. Accion has conducted and published studies on important themes affecting the sector, including supervision and regulation of MFIs.
>
> **The World Council of Credit Unions (WOCCU)**: provides mainly technical assistance and training to strengthen credit unions and credit union systems throughout the world. Most of WOCCU's programs are financed by USAID Missions and centrally funded programs. WOCCU has done very little in the way of applied research.
>
> **The Foundation for International Community Assistance (FINCA)**: using village banking technology, FINCA implements credit, savings and training programs for women's groups in 17 countries.
>
> **Ohio State University**: has been a leader in conducting scientific research on microfinance. The University's Rural Finance Department has emphasized research on lending technologies and other aspects of

MFI service delivery, as well as studying aspects of rural microfinance.

Freedom From Hunger: similar to the FINCA model, FFH has developed programs to deliver credit with education. Its programs focus on the rural poor. FFH puts considerable emphasis on evaluating the impact of its programs, and has published several studies on the topic.

Other Private Institutions:

Two institutions, PROFUND and IPC/IMI, have brought together private investors and institutions to create entities specializing in making equity investments in microfinance institutions. PROFUND is based in Costa Rica, and IPC/IMI is based in Germany. While PROFUND looks for well established institutions with strong governance and management, the IPC/IMI model prefers start-up institutions where IPC can manage institutional operations through management contracts. Both institutions have executed numerous equity investments in Latin America.

C. Key Areas of Focus for Future Assistance

As described earlier, Phase II of microfinance development in the region involves much deeper and more focused MFI institutional strengthening than Phase I involved, as well as the establishment and consolidation of MFIs within their national financial markets. These new challenges for MFIs have important implications for donors and other institutions providing assistance. Donor interventions will have to be more selective and more technically sophisticated. What follows is a summary of the major areas of support that will be required to build strong microfinance institutions and markets in the region.

MFI Institution Building

Some of the institutions that are still in the process of achieving scale and sustainability will require continued technical assistance in areas such as financial management and policies as well as management information systems development. The more advanced institutions, of which there are dozens in the region, will require technical assistance to improve operational efficiencies, to develop new products and services and to improve their marketing capabilities.

More than ever before, technical assistance programs to MFIs will have to be highly customized to the needs of individual institutions. The effectiveness of such programs will depend on accurate assessments of MFI needs, which favors the types of assistance organizations with field presence and that can act as partners with the MFIs. The methodology used by Accion International (as well as other international NGOs) is probably the most effective. Its technical assistance programs usually consist of full-time personnel who are integrated within new or existing divisions of the MFIs. This approach increases the probability of the adoption of and institutionalization of the recommendations from technical experts.

Technical assistance is widely available to most MFIs in the region from the following institutions and programs (not an exhaustive list):

IDB
USAID Missions
Other Bi-lateral Agencies
Accion International
FINCA
Freedom From Hunger
WOCCU
PLAN International
USAID Microenterprise Unit's Microserve Project
USAID Microenterprise Unit's PRIME Fund
Host Government Technical Support Programs
UNDP's Special Unit for Microfinance (SUM)
CGAP (very limited T.A., as CGAP's emphasis is on Africa and Asia)

Financing Institutional Growth

The operational costs associated with MFI expansion over the past decade have been financed largely by grants from donor institutions. Although this type of assistance is still prevalent, especially for opening new branches in remote geographical locations, most of the strong MFIs have demonstrated that they can finance such expansion by re-investing profits or through debt and equity financing mechanisms. Some of the most successful microfinance institutions, including BancoSol in Bolivia and BancoSol in Ecuador, have an average cost of capital that is comparable or higher than their commercial bank counterparts.

On the other hand, even many of the strongest MFIs in the region have struggled to finance their growth. This is especially true for unlicensed institutions that have been unable to become integrated into their country's formal financial system. It has been more difficult for these institutions to attract private equity investors, issue bonds, access inter-bank loans or access financing from the central bank. For these institutions, creative donor financing mechanisms can make an important contribution to their sustainable growth. The following list, which is not meant to be complete, lists some of the key institutions with plans to continue financing the growth of MFIs. These institutions are either donors, non-profit institutions or socially motivated investors. The list does not include pure commercial investors:

Institutions	**Programs**
IDB	Direct Loans; guarantees
MIF	Loans; equity investments

UNDP	Grants
USAID Missions	Grants; indirect (3rd party) equity investments
IFC (World Bank)	Equity Investments
CAF (Corp. Andina de Fomento)	Loans; equity investments
Accion International	Loans; guarantees; equity investments
Women's World Banking	Guarantees; equity investments
RAFAD (Switzerland)	Guarantees
Other Bi-lateral Entities	Loans; guarantees; equity investments (Swiss)
Host Government Institutions	Loans; guarantees
PROFUND and IPC/IMI	Equity Investments
Other Socially Motivated Investors	Equity Investments

The many institutions above are implementing diverse programs, some of which are particularly creative and deserve special note. Accion International has developed two a guarantee program (BRIDGE Fund) and an equity investment program (GATEWAY Fund). The Gateway Fund, in turn, has invested in PROFUND, a private for-profit entity in based in Costa Rica. PROFUND looks for MFIs with strong management and promising futures. It takes equity positions in these institutions. PROFUND's goal is to earn positive returns while its equity allows the MFIs to expand their services.

Another model, implemented by both the MIF and the CAF, is designed to assist NGOs in making the transformation to formal, regulated financial institutions. Under these programs, the MIF and CAF agree to play the roles of founding shareholders. These programs are important not only because the capital permits the NGOs to meet minimum capital requirements, but also because they demonstrate votes of confidence in the NGOs by outside institutions.

Public Goods for Industry Development

The maturing of MFIs throughout the region has led to industry level issues, some of which are described in the previous section "MFIs Can't Grow in a Vacuum." These issues are of concern to a wider group of institutions beyond individual MFIs. They concern industry associations, government authorities and other groups involved with financial markets. Assistance programs in this area result in "public goods" such as information, laws, regulations and policies. By definition, the successful creation of public goods requires the participation, coordination and often collaboration among multiple institutions with varied interests.

Effective solutions to industry level issues depend on a series of steps, including:

(1) The development of a body of research and comparative experiences used to inform decision makers,
(2) A strong interest by local institutions to develop solutions, including strong leadership from one or several individuals,
(3) A process of educating the institutions and individuals with a stake in the issue. This process requires the effective transmission of research materials to the field

and appropriate consensus building activities, including technical and other assistance to develop solutions to industry wide problems.

The past five years have witnessed a surge in the amount of information collection and publications on microfinance. Much of this information concerns lessons about best practices for individual MFIs. But a growing body of information is also becoming available on issues concerning the industry as a whole. Following is a list of some of the institutions focussing on the collection, analysis and publication of these materials:

Institution	**Programs**
CGAP and World Bank	Laws and Regulations; Savings Mobilization; MFI Standards; Training Materials Development
IDB	Laws and Regulations; Credit Bureaus; Rural Microfinance MFI Standards and Ratings, New Products and Services
USAID's Micro Unit (MBP and AIMS)	Laws and Regulations; Credit Bureaus; Rural Microfinance New Products and Services
Ohio State University	Rural Microfinance; Savings Mobilization; Laws and Regulations
UNDP (SUM)	Savings Mobilization
Microfinance Network	Laws and Regulations
Accion International	Laws and Regulations; New Products and Services; Training Materials Development

Materials and publications only have value when they are effectively disseminated. While most of the materials above are listed on the Internet, they must be purchased and usually shipped overseas from the U.S. Few development institutions have engaged in the aggressive dissemination of their publications. Unfortunately, only a fraction of these materials are available in Spanish, which further limits their usefulness. Despite these limitations, many individual institutions in the region can access high quality studies and other materials for their beneficial use.

Solutions to the industry level issues identified require more than the simple dissemination of relevant materials. They often require an extensive process of consensus building, negotiation and expert technical assistance. There is a gaping hole in this area of development assistance. None of the donor institutions have effectively brought the benefits of their studies to the field through workshops and other mechanisms. The IDB, USAID and other institutions occasionally hold seminars and conferences on relevant topics, but these are usually one-time regional or worldwide events that address the issues in a relatively superficial manner. Examples of these are the 1994 worldwide summit on microfinance in Washington, the 1998 conference on rural microfinance in Bolivia and the 1999 conference on the commercialization of microfinance in Brazil. These events, while effective at inciting the *interest* of participants, do not initiate the process of developing solutions by *involved* institutions. To begin with, their attendees are too disparate. Second, the format of such events consists mostly of presentations, with scant attention to practical exercises and participant interaction. Too often the issues addressed become closed when the events close.

Each of the institutions listed above that collect information and produce studies also have explicit programs of dissemination. In practice, though, their dissemination programs are weak. This is true of the bi-lateral and multi-lateral donors, as well as with academic institutions.

Accion International and the German firm IPC are among the only organizations that have focused resources on institutionalizing public goods. They have worked on issues such as regulatory/supervisory reform, the formation of credit bureaus, the application of MFI standards, employee training and new products and services development. The impact of Accion's and IPC's assistance has been limited by their affiliation to specific MFIs. Many of the public goods produced by these organizations is shared only with affiliate organizations.

The IDB has approved and begun implementation of a large technical assistance grant to Bolivia's Superintendency of Banks. It remains to be seen whether this program will add value to supervision in Bolivia, since the Superintendency itself has developed a relatively strong capacity in this area.

CGAP has also embarked on an innovative sector-level initiative in the region. It has provided WOCCU with funding to establish and manage a private regulatory structure for Guatemala's strong credit unions. Under Guatemalan law, credit unions were not required to be prudentially supervised in order to capture the public's deposits, but these institutions wanted to be regulated because they felt it would improve their public image and differentiate them from the country's poorly managed credit unions. CGAP has provided operational support to WOCCU and funds to advertise to the public the fact that that these credit unions are regulated. The program is still in a very early stage of development, and should be observed closely as a potential model for other countries.

In recent years, USAID Missions have increased their support to public goods development. Although certain issues are being addressed in several countries, such as regulation/supervision of MFIs, there has been very little collaboration among Missions. Below are some of the issues being addressed by USAID in the region:

Bolivia	Regulation/Supervision; Microfinance Training
Dominican Republic	Policy Support; Microfinance Training
Ecuador	Microfinance Training
El Salvador	Regulation/Supervision
Guatemala	Laws and Regulations
Honduras	Regulation/Supervision
Peru	Regulation/Supervision

D. What Role should LAC/RSD play in Microfinance Development?

The microfinance sector, in LAC and around the world, is experiencing a period of hearty assistance from donors and other institutions. For this reason, together with the fact that that microfinance has become more advanced and sophisticated, it has become more difficult for assistance organizations to add value to the sector. Some donors are even competing to provide assistance to the same MFIs. Donor institutions with significant resources, such as the IDB, have had to lower their standards in order to provide assistance to some institutions. In particular, abundant resources are now available for the institutional strengthening of MFIs and for the financial expansion of MFIs (guarantees, loans and equity investments).

Still, LAC/RSD can play an important role in the sector, provided it: (1) considers its institutional strengths and weaknesses; and (2) carefully identifies areas of need not being addressed adequately by other donors.

LAC/RSD's financial and technical resources are limited relative to other institutions. Furthermore, the Office's physical proximity to the region would make adequate supervision and monitoring of field programs almost impossible. LAC/RSD should avoid working directly with MFIs. There are other better positioned institutions (field Missions, the IDB) investing tens of millions of dollars in support of institutional strengthening and other programs.

In analyzing LAC/RSD's comparative advantages, first it is important to recognize the Office's regional nature. This fact favors a regional approach to implementation. As the Problem Analysis explains, there are a number of issues common to the region, especially issues at the industry level. These issues are not being adequately addressed by other donors, particularly with regard to dissemination and consensus building.

Second, the LAC/RSD is in an excellent position to leverage the resources of and collaborate with partners and other counterparts. These include the IDB, CGAP and USAID's Microenterprise Office, as well as U.S.-based NGOs such as Accion and FINCA. All of these institutions have offices in Washington D.C. LAC/RSD also has a unique asset in its relationship with USAID missions throughout the region, the majority of which are implementing microfinance programs. Mission staff will be able to collaborate with LAC/RSD by: (1) identifying important microfinance issues; (2) contacting relevant institutions and individuals in their for input and participation in LAC programs; and (3) following up on LAC's initial program work.

The implementation strategy focuses around a structured, yet dynamic program to provide the region with the public goods so vital to the sector's further development. This is an appropriate niche for LAC/RSD that is not being filled by other institutions. Despite a growing body of studies and other information on microfinance best practices, there have been no systematic efforts to transmit this information to those institutions throughout the region who most need it. Until now, the principal beneficiary of the research has been a small community of academics, donors and NGOs.

The proposed program will provide institutions in the field with the tools they will need to develop important policies, laws, regulations and services in their countries. These tools will include highly practical, interactive workshops designed to disseminate best practices, as well as follow-up technical assistance and other support to carry through the momentum gained in the workshops.

The most important determinant to success will be the degree to which programs are demand driven. LAC should use some of the following criteria to select the issues and countries in which they work:

(1) The industry wide issue is appropriate to the industry's development,
(2) Key local institutions have expressed interest, or at least a disposition, to develop industry wide solutions (including government institutions), and
(3) Leadership exists to build consensus and solutions.

E. Analysis and Consultation Process

The elaboration of this strategy and results package began with comprehensive assessments of: (1) microfinance development in the region; and (2) the role and programs of other donors and institutions in supporting microfinance. An initial survey was sent to USAID Missions, followed by a request for feedback on the strategy and draft implementation plan. Mission responses provided information about the numbers of MFIs, their legal status (NGO, bank, credit union, etc.), the relative strengths and weaknesses of the MFIs, and their markets. Although most of the Mission programs focus on direct support to and strengthening of MFIs, feedback revealed how important sector-level issues have become in many countries. An analysis of recent microfinance research, as well as discussions with other leading donors, further emphasized the emergence of industry-wide issues as critical to the development of healthy microfinance markets in the region.

The sector-level issue receiving the most attention has to do with the licensing, regulating and supervising of MFIs. Most of the key donors and other institutions that conduct research have studied this issue recently, and have generally concluded that the regulation and supervision of microfinance requires distinct approaches. At least five USAID Missions are providing support to this and other policy and regulatory issues. The implementation of regulatory and supervisory structures greatly varies in the five countries. At one extreme, Bolivia has had an official regulatory framework for over four years and has subsequently concentrated on the area of effective supervision. At the other extreme, El Salvador has no short-term plan for developing a regulatory framework, and the existing regulation requires nearly $6 million in initial equity capital for a banking license.

Despite the growing interest and publications on regulation and supervision of MFIs, there have only been a few spotty efforts to coordinate and share experiences across countries. These have resulted in the participation of high level personnel

(Superintendents or Assistant Superintendents of Banks, for example) at once-a-year conferences that address the issue in a cursory manner. Representatives from USAID Missions as well as other donor institutions agreed that the cross-fertilization of experiences across countries would be of great value to the development of this relatively new field.

All of the issues chosen for the LAC strategy were identified through this combination of USAID Mission feedback, a thorough review and analysis of recent studies and publications, and discussions with other partners and stakeholders including the IDB, World Bank, consulting firms and international NGOs.

It is evident that support to microfinance in the region has grown over the past five years, especially in terms of direct assistance to MFIs. The recent maturing of MFIs and their respective markets has also resulted in a growing body of research on microfinance. This research could provide tremendously useful information for decision-makers throughout the field, from MFI executives to lawmakers to potential investors. Unfortunately, there have been no systematic efforts to effectively disseminate and make use of research results, with the exception of some international NGOs such as Accion that provide technical assistance directly to their affiliate MFIs. This failure to transmit lessons learned back to the field is most serious with regard to sector-level issues. Whereas the process of dissemination and adaptation is much simpler when it concerns a single institution (e.g. new lending technologies for MFIs), it becomes much more complicated when it concerns an entire sector. Different types of institutions with different roles and at times conflicting interests need to be informed and involved in the development of sector solutions. Therefore, in addition to information, these institutions need support in facilitating a process of negotiation and/or consensus building.

The IDB, CGAP and USAID's Microenteprise Office are some of the leading institutions in the area of microfinance research. Whereas all are in the process of accelerating their research programs, they admit to being generally ineffective at dissemination. They agree that more is needed than simply publishing studies and making them available by mail or through the Internet. Rather, programs need to be designed and implemented that specialize in dissemination and in assisting institutions with adopting new practices. The institutions with worldwide coverage, such as CGAP and USAID's Microenterprise Office, are spread too thinly to effectively implement such a program. The IDB, although focused regionally, is oriented towards large financial investments as opposed to relatively low-cost investments requiring significant human resources.

In the private sector, when a company finances research, it does so because of the potential benefits of that research to its own product or market development. Therefore, research conducted by the private sector is almost always utilized. Donor financed research activities, on the other hand, tend to inadequately address dissemination and utilization. Many donor financed research projects provide funding for extensive research, but only minimal funds for dissemination. Some include only enough funds for a handful of photocopied reports. Many of the MFIs that have been the subject of major research projects have not even received copies of the completed report.

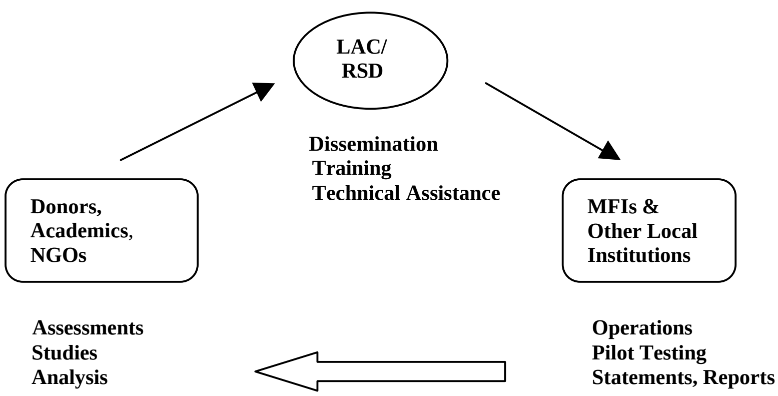
LAC/RSD's partners and other stakeholders agree on the growing importance of cutting edge research and information to the development of microfinance in the region. All have expressed enthusiasm about and support LAC's potential role in providing the region with the opportunity to utilize the information in strengthening their institutions and their microfinance sectors.

III. ACTIVITIES TO ACHIEVE STATED RESULTS

A. Summary of Expected Results

Whereas most of the current efforts in microfinance are oriented towards *institution building*, this program will be oriented towards *sector building*. Likewise, whereas most donor programs provide *direct assistance* to individual institutions, LAC's strategy is to make valuable *public goods* available to the microfinance sector throughout the region. Much of these goods will come in the form of "information." It is hoped that this information will be used to achieve progress in the sector through laws and regulations, the creation of inter-institutional mechanisms (e.g. credit bureaus) and the development of new services and technologies.

The success of the LAC/RSD strategy is inextricably tied, backward and forward, to other groups of institutions. It is tied backward to the institutions that will conduct primary research and that will make these materials available to LAC/RSD. The program's ability to design quality dissemination programs will depend on the cooperation of these institutions and individuals. The program is tied forward to the diverse groups of host country institutions that must express demand for the LAC program. Its benefits will depend on the ability of these institutions to build on the dissemination program through political will and country-level initiatives. These sets of inter-institutional relationships are depicted in the following diagram.



On a broad level, an important outcome of this program will be the improved coordination among donors and other institutions in the microfinance sector. The LAC program will analyze and reveal where donor efforts are complementary or symbiotic, and in other cases where they may be duplicative or even wasteful. By compiling studies and other information on certain themes, LAC will be able to identify areas requiring further study. These efforts will lead to a more efficient use of resources by support institutions throughout the region.

Secondly, as the implementation plan will involve open interaction with a variety of key microfinance representatives in the field, it will result in rich feedback that will inform the donor development process. In other words, the LAC program will become a primary link between development stakeholders and customers. The role of LAC will be to link the two groups through two-way communication by both providing information and by receiving feedback.

As discussed above, LAC/RSD's ability to develop more supportive microfinance environments depends on the performance of other groups of institutions linked to LAC, especially host country institutions. The provision of quality public goods is not in itself sufficient to create more supportive microfinance environments. The value of LAC's workshops and other tools will not be easily measured, but it is expected that specific outcomes will be accomplished as a result of the program.

The first intermediate result, **IR 2.1 Supportive Environments for Microfinance Developed**, will result in sector-level efforts that will facilitate the healthy development of national microfinance systems. It is expected that at least two LAC countries will design and pass legislation on new regulatory/supervisory structures for microfinance. In addition, the LAC program will lead to the improvement of existing supervisory programs in two other countries.

Similarly, it is expected that at least two new credit bureau systems will be developed and functioning as a result of the LAC program, and that another two existing credit bureau systems will be improved as a result of the program.

The second intermediate result, **IR 2.2 Improved MFI Performance through the use of New and Improved Products and Technologies**, will result in the development, testing and eventual widespread implementation of at least three new products and services for MFIs. Possible new products and services include hand-held computers, credit scoring, new credit instruments and new savings products.

IR 2.2 will also result in an increased level of transparency in MFIs through the use of an industry-wide rating system for microfinance service providers. By the end of the project, most major MFIs in the LAC region will publish objective, standardized institutional and financial data on a regular basis.

B. Activities Planned

IR 2.1 Supportive Environments for Microfinance Developed

The purpose of this sub-intermediate result is to help Latin American countries build supportive environments for microfinance sector development. MFI growth throughout the region has led to new developments including (1) a high level of competition in some markets, (2) client over indebtedness, (3) increased competition for donor resources, and (4) new products and services. Some of these developments will require new initiatives at the sector level to support the continued growth, sustainability and diversification of microfinance. An example of this would is the formulation of appropriate regulatory frameworks that would allow qualifying institutions to mobilize client deposits. Or, in other cases, sector level initiatives may be needed to prevent the market's deterioration. An example of this would be the creation of a well functioning credit bureau system that would allow MFIs to ensure that potential clients do not have delinquent loans with other institutions.

There is no simple sector level solution to building supportive environments for microfinance development. The issues are diverse and changing fast. While some issues may require the passage of a new law, others may require the creation of new institutions. In addition to the two issues mentioned above, other potential sector level initiatives may include:

- The development of quality programs to upgrade the skills of MFI employees,
- The establishment of national systems allowing financial institutions to use movable assets as collateral for loans, and
- The formulation and implementation of host country policies on donor support to microfinance.

Presently, most of the five topics listed above are relevant to most of the countries in the region. Some have already been addressed by some countries to varied degrees and with varied degrees of success. What is certain is that these issues will continue to change over the five-year LAC strategy period. Some issues will be resolved and new issues will materialize. Therefore, it is essential that this sub-IR be managed with the flexibility to respond to new issues as they arise. The criteria to be used to choose sector level initiatives includes:

1. Since LAC/RSD will not be conducting primary research, a relevant body of current information and knowledge on the topic must already exist, i.e. there must be some useful lessons and/or technologies to bring to the field. LAC/RSD should also consider to what extent other donors and institutions are already adequately addressing the issue. Where this is being done, LAC/RSD should avoid duplicating others' efforts.
2. An assessment of the demand from host country institutions (including MFIs, associations and government entities) for addressing the issue. These assessments can be done in large part with the collaboration of USAID Missions.

Based on these criteria, there are currently three issues that justify immediate attention. They are:

1. The formulation and implementation of well functioning regulatory and supervisory systems.
2. The creation of well functioning credit bureaus for microfinance institutions and their clients.
3. The development of improved programs to train MFI employees.

a. **Knowledge of Regulatory and Supervisory Functions Increased**

Microfinance institutions have grown significantly throughout the Latin America and Caribbean region. In some countries, these institutions serve more clients than the entire traditional commercial banking sector. The continued growth and stability of microfinance will require increased sophistication in many areas. One of these areas concerns prudential regulation and supervision.

From the perspective of the microfinance institutions, financial regulation is highly desirable. Obtaining a license from a regulatory body is a critical step in breaking from a dependence on donor funding. Whereas an unlicensed institution has limited sources of financing, usually restricted to donors, a license permits an institution to raise capital in a number of ways, including:

- Deposit taking from the public,
- Inter-bank loans, and
- Issuance of bonds and other debt instruments.

Furthermore, such a license usually allows a financial institution to leverage its equity by a ratio as high as 12 to 1. While most unregulated microfinance institutions operate at a debt to equity ration of no more than 2 to 1, a license provides an opportunity to multiply an institutions' lending portfolio by another 600 percent.

Finally, unregulated financial institutions are usually limited to the service of providing loans. Microenterprises have demonstrated a strong need for other services, especially savings and transfers, as well as leasing, insurance and others. These services can only be developed and provided by licensed financial intermediaries.

From the perspective of regulators, prudential regulation and supervision of MFIs is probably not necessary for institutions that do not take deposits from the public. Should these institutions desire, they can create self-regulating mechanisms. For those MFIs that do wish to take deposits, the regulators must find appropriate ways to regulate and supervise these entities in order to protect depositors and to maintain a healthy financial system.

The implications of regulating MFIs are complex, both for the MFIs themselves and for the regulators. For the MFIs, obtaining a license from a regulatory body may require significantly heightened levels of transparency and information disclosure. It will require meeting diverse requirements with regard to ownership structure, management, security and reporting. It may require inviting and accepting new private investors to join the institution, as in the case of most institutions that have formed FFPs in Bolivia. Such actions often require a re-analysis of institutional philosophy and goals.

For the regulatory bodies, supervising MFIs is not as simple as applying standard commercial banking requirements. MFIs differ greatly in some very important ways from commercial banks. First, MFI lending methodologies are based on non-collateral guarantees. They usually involve limited loan documentation, and are relatively very costly to manage (administrative costs of MFIs are typically 4 times greater than their traditional counterparts). Second, MFI loan portfolios consist of a much greater quantity of small loans with shorter maturity and more numerous payment requirements. It has also been demonstrated that MFI loans have more volatile delinquency characteristics, i.e. once a micro-loan becomes delinquent for only a few days, the probability of non-repayment is higher than it would be for a larger, commercial loan. Finally, the institutional structure and governance of MFIs differ greatly from traditional banks. Their shareholders are usually non-profit institutions, and their management is usually less technically qualified in the area of finance.

The differences outlined above must translate to differences in the methods used by regulators to license and supervise MFIs. These differences are most likely in areas such as minimum capital requirements, capital adequacy, and loan loss provisioning. More importantly, the regulators will have to develop the means to adequately assess portfolio risk. Such means are now being explored in some countries such as Bolivia and Peru. The lessons learned from these experiences will be important to regulators throughout the region.

Dozens of MFIs throughout the region have expressed their intention to be regulated and supervised. Only a few countries have developed and implemented such frameworks, namely Bolivia and Peru. The MFI sectors in some other countries, including Ecuador, Nicaragua, El Salvador and Honduras, have reached a level of size and maturity that warrants the development of a sound regulatory and supervisory systems. Despite this, a 1997 study carried out by the IDB revealed a neutral to cautious attitude on the part of regulators about licensing MFIs. Nonetheless, there is a realization by many of these regulators of a need to learn more about this growing sector and to prepare themselves to regulate MFIs in the future. A third group, government authorities and policy-makers, are interested in continuing the expansion and formalization of the microfinance markets in their countries. They are generally supportive of efforts to regulate and supervise MFIs.

The purpose of this program is to provide the three groups above (MFIs, regulators/supervisors and government authorities) with the benefit of recent experiences and knowledge gained about the regulation and supervision of MFIs. This information can serve as an important tool to allow participating institutions to move forward in developing appropriate regulations and supervisory capabilities in their own countries. The program will also be used to help establish consensus among institutions about what needs to be done and about what roles should be played by which institutions.

<u>Specific Activities</u>:

1. Conduct secondary research on supervision and regulation of MFIs throughout the region and the world by compiling and analyzing publications and other documents about the theory and practice of microfinance regulation and supervision. The sources and/or authors of these documents should be

interviewed to gather further information and insight. These sources include multi-lateral and bi-lateral donors such as the IDB, CGAP and USAID's Microenterprise Office, as well as private organizations such as Development Associates, IPC and Accion International.

2. Gather primary data and other information about recent experiences in regulating and supervising MFIs. This will include relevant laws, regulations, norms, bulletins and other official documents published in countries where the regulation of MFIs is taking place. Key personnel from involved institutions such as bank superintendencies and regulated MFIs should be interviewed.
3. Analyze, condense and organize secondary and primary research into a useable format.
4. Design a series of workshops intended to inform interested institutions about recent experiences and knowledge about regulating and supervising MFIs. At least two detailed case studies should be presented. The benefits and pitfalls of regulation should be discussed from the perspectives of both the MFIs and the regulators. The workshops should address the following technical considerations:

   - Minimum capital requirements,
   - Capital adequacy requirements,
   - Governance and ownership requirements,
   - Management experience,
   - Limitation on the services MFIs should offer,
   - How a supervisory body should structure itself,
   - Should supervision be contracted out? Why and when?
   - When is self-regulation a preferred option?
   - How to supervise at a reasonable cost,
   - How to assess portfolio risk in MFIs,
   - Loan classification and provisioning,
   - Reporting requirements and periodicity, and
   - Fraud prevention.

5. Based on consultation with LAC/RSD, USAID Missions and other institutions, determine the three countries in the region with the highest expressed need and desire for developing regulatory frameworks for MFIs.
6. Organize and conduct workshops in each of the three identified countries. The workshops should emphasize two methods of sharing information and best practices with participants. First, qualified international experts should share the results of research and best practices. Second, practitioners from other countries with experience in regulation and supervision (Bolivia and Peru) should be invited to relate their experiences in a substantive manner.
7. A great deal of attention should be given to identifying and inviting representatives from institutions which will be affected by the regulation of MFIs. These would probably include lawmakers, regulatory authorities, supervisory authorities, Ministries of finance and other government entities involved in economic development and/or microfinance, MFIs, associations of microfinance institutions and donors.

8. In addition to informing workshop participants about recent experiences and knowledge, the workshops will include a second component whereby participants initiate a process of developing an appropriate regulatory and supervisory structure for their own countries. Exercises will allow participants to begin a planning process, including steps to be taken, the roles of different institutions and timelines. It is important that the LAC workshop hosts assume the role of facilitator during this component of the workshops. They should avoid participating in substance and should especially avoid influencing groups to accept propositions that may be technically or politically against their interest.
9. The contractor will carefully record workshop proceedings, which will be condensed and disseminated to other persons and groups, appropriately.

In order to be effective, workshops usually require follow-on support activities, especially in the form of technical assistance. The LAC/RSD program could provide technical expertise under its programs or, alternatively, could coordinate collaborate with other institutions that already provide technical assistance. With LAC or Mission financial support, technical assistance is currently available through USAID Global Bureau buy-in mechanisms. The IDB may also be interested in developing a technical assistance facility for this purpose.

b. **Understanding of the Role of Credit Bureaus Increased and Applied**

Credit bureaus have become a widespread, useful tool to traditional financial sectors all over the world. But until recently, they have been entirely absent in the microfinance world. Given the lack of physical guarantees in microfinance, there is a strong need for other mechanisms to assess credit risk. Credit bureaus provide such a mechanism.

In some countries, including Bolivia, Peru and Nicaragua, competition has intensified as markets have become nearly saturated with micro loans. New, well qualified clients have become more scarce in these markets. The widespread availability of credit, combined with aggressive efforts by MFIs to find new clients, has led to over indebtedness and, consequently, to increased delinquency rates.

The loan application and approval process for micro credit is far simpler and less rigorous than the process used for larger, traditional loans. Due to the absence of collateral in these programs, defaulted loans usually result in 100 percent loss for the MFIs. Even when collateral is available and recoverable, the cost of doing so is prohibitive.

Licensed, regulated MFIs are usually required to disclose information about all their clients to the prudential supervisory body in their country. This information, in turn, can be made available to other institutions to evaluate the credit risk of potential new clients. In Bolivia, the Superintendency of Banks itself manages the credit bureau system by providing on-line, up-to-date client information to all regulated institutions.

Bolivia's system covers the majority of micro credit clients, but it excludes those clients receiving credit from NGOs and other unregulated institutions. Throughout the rest of the region, the great majority micro credit clients are served by unregulated institutions. This has important implications for the development of credit bureaus. First, MFIs will have to participate on a voluntary basis. Developing a voluntary system requires that MFIs perceive a demand for the service (that they are willing to pay for). It also requires that a sufficient level of trust be developed among MFIs that would allow them to share client information. Second, the creation of a credit bureau system for unregulated MFIs would have to be initiated by MFIs themselves and would have to be implemented by a private institution. With support from USAID/El Salvador, a group of non-profit MFIs in El Salvador has created a new credit bureau institution called INFORED. In Peru, on the other hand, an existing credit bureau firm was contracted to provide services to the MFIs. In either case, credit bureaus must have adequate scale and pricing which allows them to be sustainable.

Other countries in the region will need to develop credit bureaus for microfinance in the near future. The USAID Mission in Mexico has already expressed an interest in supporting the development of a credit bureau there. Even those countries where credit bureau systems for microfinance have been developed will require further support and refinement. In particular, they would benefit from technical expertise from first world countries and from sharing their experiences with one another.

The credit bureau development program will consist of the following activities:

1. Conduct a survey of the microfinance credit bureaus currently functioning or being developed in LAC countries. The purpose of the survey is to gather general information about the credit bureaus and to assess their relative effectiveness.
2. Identify experts with experience in the design and creation of well functioning credit bureaus. Based on their work and on an understanding of the current situation in LAC, these experts should design highly practical workshops for MFI representatives and other interested parties in the region.
3. Identify individuals and institutions within LAC with experience in the design and implementation of microfinance credit bureaus. Some of these individuals should be invited to participate in dissemination events.
4. Working through USAID Missions, identify LAC countries with an expressed demand by local institutions for credit bureau systems and a willingness to develop such systems.
5. Conduct highly practical and interactive workshops in two to three LAC countries. Possible candidates would include Bolivia, Peru and El Salvador where systems have recently been launched. Other candidate countries would be Ecuador, Nicaragua and Mexico where interest has been expressed.
6. Workshops should be conducted by individuals identified as experts in facilitating effective workshops, but should also include the participation of technical experts on credit bureaus and individuals from other LAC countries that have been recently involved in credit bureau development. The purpose of these workshops is twofold. First, they should provide local institutions with new knowledge about credit bureaus. Second, they should facilitate initiatives by local representatives

of these institutions to develop (or refine) their own credit bureau systems. Some of the relevant issues for discussion will be:

- What is the purpose of a credit bureau system?
- How should credit bureaus be organized? Who should organize them?
- What are considerations in developing a private versus public system?
- Which institutions should participate? Should credit bureaus be specific to microfinance or should they be more inclusive?
- What institutions should be responsible for managing credit bureau systems?
- What information should be reported and maintained within the system?
- How can trust be built among participating institutions? Should the type and amount of information reported increase gradually to build trust?
- What are the information system requirements needed for developing credit bureaus? What kind of software is required?
- Why is it important that credit bureau information be complete and that it be updated frequently? How can this be achieved?
- What are the security implications and safeguards required?

7. These workshops should be limited to about 25 participants to ensure a high level of interaction among them. Fees should be charged for workshops to ensure they are valued by participants. The proceeds could be used to create and maintain a fund to be used exclusively for follow-on activities related to credit bureau development in the relevant country.
8. After a series of workshops is completed, major issues and conclusions should be summarized in a brief paper that should be distributed widely to Missions, MFIs, associations, donors and other institutions.
9. Follow-on technical assistance should be made available on a demand basis to develop credit bureau systems in individual countries. This assistance can be provided through LAC financed activities or through buy-ins by Missions to Global Bureau activities.

c. **MFI Human Resources Improved**

MFIs throughout the region have expressed concern over inadequate human resource capacity within their institutions, especially at the middle management level. The need for better trained employees has grown out of: (1) rapid growth and increased sophistication of many MFI programs; (2) increased competition; and (3) increased reporting requirements resulting from the formalization of MFIs.

International training opportunities (Economics Institute in Boulder, Harvard, Frankfurt Seminar), due to their high cost and language requirements, are available to only high-level managers from the MFIs. Middle and lower level employees are relegated to local training programs in management and banking. Microfinance-specific training programs are rare in most Latin American countries. Those that do exist are usually conducted by institutions that do not specialize in microfinance. As a result, the training programs do not respond to the pressing needs of the MFIs.

Some of the most important aspects of quality microfinance training include:

(1) Quality curriculum that respond to the needs of MFIs and their employees,
(2) Competent instructors with technical expertise,
(3) The right mix between theory and practice, with an emphasis on practice,
(4) Strong logistical support.

Successful, sustainable training programs are usually managed by well organized, sustainable institutions. In this project, LAC/RSD should not engage in institutional strengthening of any kind. Such efforts should be left to local institutions. Nevertheless, LAC/RSD can make an important contribution through the development and dissemination of high quality training materials in the Spanish language. These materials could be adopted by local training institutions and incorporated into their curricula.

This program should consist of the following activities:

(1) Identify the types of training required by different employee levels and prioritize this training. Based on a regional survey conducted in late 1998, examples of priority areas include:

    - Upper Managers: strategic and business planning, financial/risk analysis, supervision and regulation.
    - Middle Managers: financial/risk analysis, human resource management.
    - Loan Officers: credit analysis, client relations.

(2) Identify existing training materials in the marketplace. Some of the best materials have been developed by CGAP and Accion. LAC/RSD should coordinate with these institutions in identifying the materials and, in some cases, translating them into Spanish.
(3) Develop new materials on topics that have not been previously addressed adequately. To the extent possible, these materials should be developed in collaboration with institutions with proven capability, such as CGAP and Accion.
(4) Package these materials in a well organized, presentable format.
(5) Disseminate materials to institutions throughout Latin America which have demonstrated capacity to deliver microfinance training. These institutions can be identified by USAID Missions.
(6) In some cases, LAC/RSD could support training institutions in the proper utilization of training materials.

Continuous review of materials and revision should be carried out.

<u>IR 2.2 Improved MFI Performance through the use of New and Improved Products and Technologies</u>

Current technology in Latin America's best MFIs allows them to manage profitable operations with fundamentally sound credit programs. As in most businesses, the important determinants of success are capable management and qualified human resources.

Still, most microfinance institutions remain highly inefficient, and their high operating costs are passed on to poor microfinance clients. They tend to offer a very limited range of financial services that may or may not be most appropriate for their clients. Even the credit instruments, which are the bread and butter of MFIs, are limited and have changed little over the years. Services such as savings, insurance, leasing and transfers are rare.

MFIs must invest in the design and testing of new technologies and products that can help them increase their efficiencies, profitability and client services. Although some efforts have begun, they are still in the early stages of development. The purpose of this Sub-IR is to support some of these efforts, especially in making the most promising technologies and products available to a wider range of MFIs.

a. Increased Efficiencies in MFIs through the Design, Testing and Dissemination of New Technologies in Credit Operations

Operational efficiency is one of the most important factors affecting the future viability of microfinance in Latin America. Even in the more mature markets, administrative costs in MFIs average about 20 percent of performing assets. This is still between five and ten times higher than administrative costs in traditional banking sectors. High operational costs affect both the MFIs and their clients. They affect the MFIs' profitability and ability to attract commercial financing; and they affect the clients through higher on-lending interest rates which, in turn, affects the well being of the region's poor.

The lending technologies employed by MFIs, although fundamentally sound, are labor intensive and costly. These high costs are concentrated in evaluating potential clients and in processing and monitoring loans. The costs associated with back office operations are also high.

This activity is designed to identify, test and disseminate the results of new technologies in the area of credit operations. The activity should consist of the following:

(1) Conduct thorough analysis of credit operations in selected MFIs including loan evaluation procedures, loan approval and processing procedures, pricing and loan monitoring and collection procedures. An overall assessment of management information systems should be carried out, as well. The analysis should identify areas where improvements in quality and efficiency are possible.

(2) Design or identify technologies that can lower costs and/or improve performance in credit operations. A possible example would be the use of hand held computers by loan officers. This technology has several potential

benefits. It could eliminate the need for transcribing loan evaluation information from the field to the office. By programming loan evaluation criteria into the computers, it may also allow loan officers to approve loans in the field. Other possible technologies include credit scoring, new credit instruments, cost based accounting systems and other improvements in MIS systems.

(3) Identify MFIs to pilot test these new technologies. MFIs should be chosen based on their expressed demand for the technology and an evaluation of the appropriateness of the institution. It is also important that LAC/RSD (i.e., its contractor or grantee) be given full access to the MFI in order to monitor and evaluate the new technology.

(4) Pilot test new technologies in selected MFIs.

(5) Evaluate the results of pilot tests. Evaluation criteria will depend on the specific technology and its application, although some general criteria should include its impact on:

- Operational costs,
- time associated with the loan operation,
- loan performance (timely repayment), and
- loan officers' portfolio quality and volume of clients.

(6) Should pilot tests draw positive conclusions, LAC/RSD should undertake a campaign to disseminate these results widely for adoption by MFIs throughout the region. Brief papers should be prepared that describe pilot test results and manuals should be developed to show MFIs how to use the new technologies.

b. Standardized Rating of USAID Supported MFIs Performed and Results Disseminated

Some donors, including USAID, the World Bank and the IDB, have undertaken the challenge of "commercializing" microfinance. Still a sector dominated by NGOs, evidence suggests that microfinance will grow and prosper only after it is fully integrated into the formal financial sector. One way of achieving this is by traditional commercial banks "down scaling" to include microfinance operations. Another way is to "upscale" NGOs through their transformation into regulated, supervised entities. Either way, the process will require informing existing and potential practitioners and investors with objective, transparent data on the sector's performance.

Wide variations exist in how MFIs throughout the region develop their financial statements. Examples of important and glaring differences are how financial costs are calculated and how delinquency rates are defined and calculated. Some institutions do not factor in inflation, while others do. These differences have a profound effect on income and other bottom line numbers. Even non-financial information throughout the MFI world is highly subjective. Most of what we read about individual MFIs is written by the MFIs themselves or their supporters.

It is difficult and often impossible to find objective, independent assessments on the overall health and performance of MFIs. The absence of this information complicates the effort to attract commercial banks and other potential investors. Recently, the Private Sector Initiatives Corporation (PSIC) developed a methodology to evaluate MFIs. The methodology involves adjusting data based on standard definitions and methods of calculation. The intended result is standardized information that allows direct comparison from one institution to another, regardless of legal status, the country in which they are found, or any other factor that might normally cloud an objective comparison.

To date, PSIC has performed a number of these institutional assessments. The assessments follow a standardized format, including financial statements and other ratios on capital adequacy, asset quality, management and earnings. Their work also involves non-financial assessments on the organizations and their credit operations. The assessments do not replace more comprehensive exercises of due diligence carried out by potential investors.

An institutional rating program has three potential benefits. First, it can be used to attract potential commercial investors – the original intention of PSIC's work. Recent experience has shown that commercial investors, by and large, are not interested in the microfinance sector. It may be years before this occurs. Still, the information has been useful in informing donors and socially oriented investors (MIF, IFC, Calvert Fund, AXA, Profund and others) on MFI performance.

The second potential benefit of institutional rating is the ability to show MFIs how they compare against one another. This information would assist institutions in assessing their own relative strengths and weaknesses, and it would help them direct their resources for institutional strengthening.

Finally, rating information would benefit donors and government authorities. It would assist donors in making decisions about which institutions to support and how to support them. Government authorities would have a greater understanding of the microfinance market in their countries, which could help them in shaping policies and regulations.

The institutional rating program should consist of the following activities:

(1) Conduct a rapid assessment of the universe of MFIs in Latin America that should qualify for being rated. The assessment should be conducted from the perspective of the three potential beneficiary groups mentioned above: investors, MFIs and donors and government agencies. Some of the institutions LAC/RSD should contact in conducting the assessment are USAID Missions, USAID's Microenterprise Office, CGAP, IDB, Profund and Accion.

(2) Contract the services of an institution capable of conducting the ratings of MFIs. The institution must have a proven rating methodology as well as technical capacity to carry out the ratings.

(3) Conduct ratings of MFIs. This should take place over no more than a 12-18 month period to ensure that the information is sufficiently current. The rating of USAID-supported MFIs should be emphasized, as this information will be useful in improving the programming of USAID resources. A minimum of 24 institutions should be rated.

(4) Compile, publish and disseminate ratings results. The ratings should be compiled in a single package to allow for easy comparison. They should be published in both English and Spanish. This information should also be made available through the LAC/RSD website.

c. Savings Mobilization Best Practices

Voluntary savings services can contribute to MFIs' in several ways. First, they contribute to self-sufficiency by reducing dependence on outside financing. They also reduce the institutions' risk through diversification of their liabilities structure. Furthermore, client deposits in microfinance institutions tend to consist of numerous small accounts, whereas institutional financing tends to be concentrated in few, large accounts. Finally, if priced correctly, savings instruments can be profitable.

There is also substantial empirical evidence demonstrating the value and importance of institutional savings services to poor clients. These services offer security, convenience, liquidity, confidentiality as well as returns to the depositor.

The purpose of this activity is to expose MFIs, Latin American supervisory entities and USAID Missions to best practices in savings mobilization. The activity should consist of the following steps:

(1) Gather first-hand information about micro savings mobilization experiences. This should focus on voluntary, not compulsory, savings programs. Information should be provided by practitioners themselves or through independent evaluations by donors or other groups.

(2) Conduct a thorough analysis of results. Each program should be analyzed separately with regard to the following:

Enabling Environment

- Macro-economy,
- Legal and regulatory environment,
- Demographic conditions,
- Supervisory oversight.

Institution Specific

- Type of Institution (NGO, bank, credit union),
- History and financial performance of MFI,
- Market demand for savings,
- Savings products employed,

- Organization (personnel, training),
- Operations,
- Physical infrastructure,
- Security,
- Marketing of products,
- Cost analysis,
- Liquidity management.

The analysis should compare all the above factors for each program, and should identify the factors that are most important to successful savings mobilization.

(3) Conduct demand-driven workshops in Latin American countries. LAC/RSD should work through Missions to identify those countries where institutions are most interested in savings. Participation should be open widely to donors, MFIs, associations and government entities. Workshops should have a duration of 2-3 days and be limited to 30 participants. It is important they have a highly practical focus, consisting of the following types of activities:

- Presentation of and discussion about study findings,
- Presentations by practitioners with savings programs,
- Individual and group exercises to develop savings models (for their institutions).

Disseminate results of comparative study and workshops. The results of the comparative analysis should be condensed into brief publications and distributed widely by e-mail to all USAID Missions and other development partners. LAC/RSD should maintain and update a complete distribution list of institutions (MFIs, donors, NGOs, associations, others) operating in Latin America.